United States General Accounting Office

GAO

Report to the Secretary of Education

August 1987

DEFAULTED STUDENT LOANS

Private Lender Collection Efforts Often Inadequate

039761

GAO/HRD-87-48

GAO United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-228676

August 20, 1987

The Honorable William J. Bennett
The Secretary of Education

Dear Mr. Secretary:

This report discusses controls established to reduce the costs of defaulted guaranteed student loans.

This report contains a recommendation to you. As you know, 31 U.S.C. 720 requires you to submit a written statement on actions taken on our recommendation to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the Department's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the chairmen of the above-mentioned committees, the Senate Committee on Labor and Human Resources, and the House Committee on Education and Labor; each guaranty agency; and other interested parties.

Sincerely yours,

Edward A. Densmore

for Richard L. Fogel
Assistant Comptroller General

Executive Summary

Purpose

Since 1965, the Department of Education, through 47 loan guaranty agencies, has paid over $4 billion to lenders for defaulted loans made through the Guaranteed Student Loan Program. Increasing default costs prompted GAO to evaluate whether the policies and procedures used by the Department and the guaranty agencies in paying default claims adequately protect the federal government's financial interest and minimize unnecessary federal insurance costs. Specifically:

- Have guaranty agencies established and enforced collection and claim filing standards for lenders that adequately protect the federal interest?
- Are the guaranty agencies promptly processing and paying lender claims?

Background

Under the Guaranteed Student Loan Program, about 13,000 lenders provided more than $9 billion in loans to about 3.7 million students for postsecondary education in fiscal year 1986. When borrowers default on loans, the guaranty agencies pay the outstanding principal and accrued interest, which totaled more than $1 billion in fiscal year 1986.

To protect the federal interest, regulations require the guaranty agencies to set and enforce procedural standards requiring lenders to (1) make all reasonable efforts to collect delinquent loans and (2) promptly file claims for reimbursement from the Department when they are unable to collect a loan so that interest (paid by the federal government) stops accruing. Lenders are to comply with the collection and filing standards in order to be paid for defaulted loans, and the agencies are to certify that lenders followed the standards in order to receive reimbursement from the Department.

Agencies are therefore expected to establish procedures for reviewing and paying lenders' default claims sufficient to assure that lenders perform their role adequately, thus minimizing the Department's default-related costs. For example, if agencies or lenders process claims too slowly, the government pays more in interest than it should for delinquent loans.

The guaranty agencies are required to submit their standards for approval by the Department of Education, which is then to determine if the standards are adequate to protect the federal financial interest. The Department also has a program to periodically review agencies to determine whether they comply with the standards.

Standards Are Inadequate

Because the Department had not set minimum requirements for what should be included in agencies' collection standards, GAO compared the standards for each of the six agencies to "benchmark" standards the Department uses when it directly insures lenders for loans. The standards for most of the agencies lacked sufficient coverage. For example, the standards for four of the six agencies did not require that lenders try to contact delinquent borrowers a specific number of times and at specific intervals, although this is generally considered to be the first step in trying to collect delinquent loans.

Compliance With Standards Not Enforced

While the six agencies have been reluctant to reject claims for noncompliance with their standards, few had established less severe penalties, such as reduced interest payments, that could be applied to lenders who failed to perform required collection actions or provide evidence that they had made reasonable efforts to collect delinquent loans. Among the standards not enforced were requirements that lenders submit evidence with their claims that they had sent delinquent borrowers written collection notices and final demand letters. Of the 300 claims sampled, GAO concluded that the agencies could have denied payment for 50 percent—with individual agencies ranging from 8 percent to 94 percent—yet they paid them all.

Federal Interest Costs Varied Widely

The number of days from the date borrowers were delinquent until the date lenders received insurance payments for defaults varied widely among the six guaranty agencies reviewed. Because interest on the loans accrues during these periods and is ultimately borne by the Department of Education, federal interest costs also varied widely. For example, the average time frames from delinquency to claim payment for the 300 defaulted loans GAO reviewed ranged from 148 to 455 days at the six agencies. Some of these variations could be attributed to differences in agencies' standards and procedures for filing and processing claims. Given the volume of claims ($414.6 million) paid by these six agencies in 1985, an average delay of 30 days in processing claims would increase federal interest costs by $4.1 million.

Revised Regulations Need to Be Enforced

In contrast to prior regulations, the Department's revised regulations (1) require that agencies set specific minimum loan collection and timely claim filing standards for lenders, (2) clarify the requirements that guaranty agencies must enforce lenders' compliance with the standards to be eligible for reinsurance, and (3) specify certain internal control

To assess lender and agency compliance with program regulations and collection standards, GAO reviewed the practices of six guaranty agencies and examined in detail files on a statistical sample of 300 claims paid during 1984.

Results in Brief

Although most of the 47 guaranty agencies developed standards for lenders' use in collecting loans and filing insurance claims nearly a decade ago, the Department has never reviewed or approved most of them. More importantly, the standards of the agencies GAO reviewed were not always adequate to ensure prompt and vigorous collection of defaulted loans. The standards were frequently not followed by lenders and were poorly enforced by the guaranty agencies.

Nevertheless, the government could have avoided unnecessary costs for insurance claims and interest paid on delinquent loans if the guaranty agencies had enforced their standards rigorously. For example, GAO estimates that in fiscal year 1984, the six guaranty agencies reviewed paid $83 million for claims they could have rejected because the lenders' collection actions fell short of what was required. Most of the agencies' procedures were also inadequate to ensure (1) lenders' prompt filing of default claims and (2) agencies' timely processing and payment of claims, with the resulting costs borne ultimately by the Department.

In November 1986, the Department revised the program's regulations to strengthen guaranty agencies' and lenders' loan collection and default claim filing activities. GAO generally endorses these revisions and believes that—if rigorously implemented by the Department and the guaranty agencies—they represent a significant step toward resolving the problems identified.

Principal Findings

Agency Collection Standards Not Approved

Although federal regulations require the Department to approve collection and claims standards for all guaranty agencies, only 9 of 47 agencies' standards had been reviewed and approved. Nonetheless, the 47 agencies received a total of about $1.3 billion in reinsurance payments from the Department in fiscal year 1986.

responsibilities of the agencies, such as biennial financial and program audits.

These changes, if implemented, should correct the problems GAO identified. To ensure timely implementation, the Department needs to systematically review and approve guaranty agencies' standards for compliance with the regulations. In this regard, the Department has not established a plan, including specific time frames, to review and approve the agencies' operating procedures, standards, and internal controls.

Recommendation

GAO recommends that the Secretary of Education develop and implement a process to review and approve minimum loan collection and claim filing standards and guaranty agency internal controls and administrative procedures. The process should include specific milestones (and time frames) for the agencies and the Department to use in submitting and approving the agencies' standards and procedures.

Agency Comments

The Department of Education generally concurred with the information and conclusions in GAO's report, but believed that the recommendation that it systematically review and approve guaranty agencies' procedures and standards could be adequately met through its periodic program reviews of the agencies' activities. While GAO agrees that the Department's program reviews are an important element of program oversight, it does not believe that such after-the-fact reviews are sufficient to ensure that the agencies have implemented the new federal requirements in a timely manner. Under the Department's current schedule, it will take about 2 years to complete such reviews at all agencies.

GAO furnished a draft of its report to the six guaranty agencies it reviewed, and the California, Connecticut, Tennessee, and New York agencies provided comments. The California and Connecticut agencies generally concurred with the conclusions and recommendation. The Tennessee and New York agencies have acted to improve their standards. However, the two agencies disagreed with GAO's conclusion that many of the claims reviewed lacked sufficient evidence that lenders had met the agencies' existing standards. (See p. 42-45.)

Contents

Introduction

The Guaranteed Student Loan Program is the largest federally assisted financial aid program available to students pursuing an education in colleges, universities, and trade schools, providing more than $9 billion to 3.7 million students during fiscal year 1986 alone. Using capital provided by about 13,000 state and commercial lenders, the program provides low-interest loans under the protection of guarantees issued by state and private nonprofit guaranty agencies. The Department of Education subsidizes the program primarily by (1) reimbursing guaranty agencies for their losses on defaults and for certain operating costs and (2) making loan interest payments to the lenders.

The guaranty agencies operate the program for the Department. A key element of the agencies' responsibilities is ensuring that lenders (1) exercise prudent lending practices—"due diligence"—in making, servicing, and collecting loans and (2) file claims for defaulted loans with the agency in a timely manner. Such actions by lenders can reduce the number and amount of lender claims and, ultimately, federal costs in support of the program.

How the Program Works

Each loan under the Guaranteed Student Loan Program involves five entities—a student-borrower, a school, a lender, a guaranty agency, and the Department of Education.

A student seeking financial aid applies directly to a lender for a loan. The student must meet certain eligibility requirements and attend a participating school. The school or the guaranty agency confirms (and periodically reconfirms) for the lender that the student is enrolled and eligible and notifies the lender when the student leaves school. After leaving school, the student must begin repaying the loan.

The lender makes the loan, under protection of a guarantee for nonpayment from a guaranty agency. While the student borrower is in school, the lender receives a base interest rate—currently 8 percent—on the loan from the Department of Education. During the life of the loan, the Department also pays the lender an interest subsidy ("special allowance") if needed to compensate it for the difference between the program's base interest rate and market rates. When a loan becomes due, the lender is responsible for collecting from the borrower. If the student fails to repay the loan because of death, disability, bankruptcy, or default, the lender files a claim for reimbursement with the guaranty agency.

The guaranty agency administers the program at the state level. Agencies issue guarantees to lenders and are responsible for setting and enforcing—subject to Department of Education regulations—standards for lenders to use in making, servicing, and collecting loans. When a borrower dies, becomes disabled or bankrupt, or defaults, the agency pays the lender for the uncollectible loan if the lender has complied with agency standards. The agency receives reimbursement—"reinsurance"— from the Department of Education for each claim paid. The agency then attempts to collect the defaulted loan directly from the borrower, retaining 30 percent[1] of the amount collected to reimburse its cost, and submitting the balance to the Department.

The Department of Education is responsible for administering the program nationwide. It establishes program guidelines; approves the participation of guaranty agencies, lenders, and schools; and oversees lender and guaranty agency operations. The Department makes payments to lenders for interest and special allowance and to guaranty agencies for reinsurance and reimbursement of certain operating costs.

While these five entities are involved in every loan, other organizations may participate. For example, a lender may sell its loans to a secondary marketing agency, such as the Student Loan Marketing Association. Also, lenders and guaranty agencies may contract with organizations to provide such services as processing borrower payments, attempting collections from defaulted borrowers, and billing the Department of Education for loan interest payments.[2]

Program Costs Are Increasing

Federal obligations to support the Guaranteed Student Loan Program are substantial, amounting to about $4 billion in fiscal year 1986 alone. Some of these costs are recovered through program revenues, such as the Department of Education's share of guaranty agency collections and loan origination fees paid by the borrowers. The remainder comes from federal appropriations, which totaled $3.2 billion in fiscal year 1986.

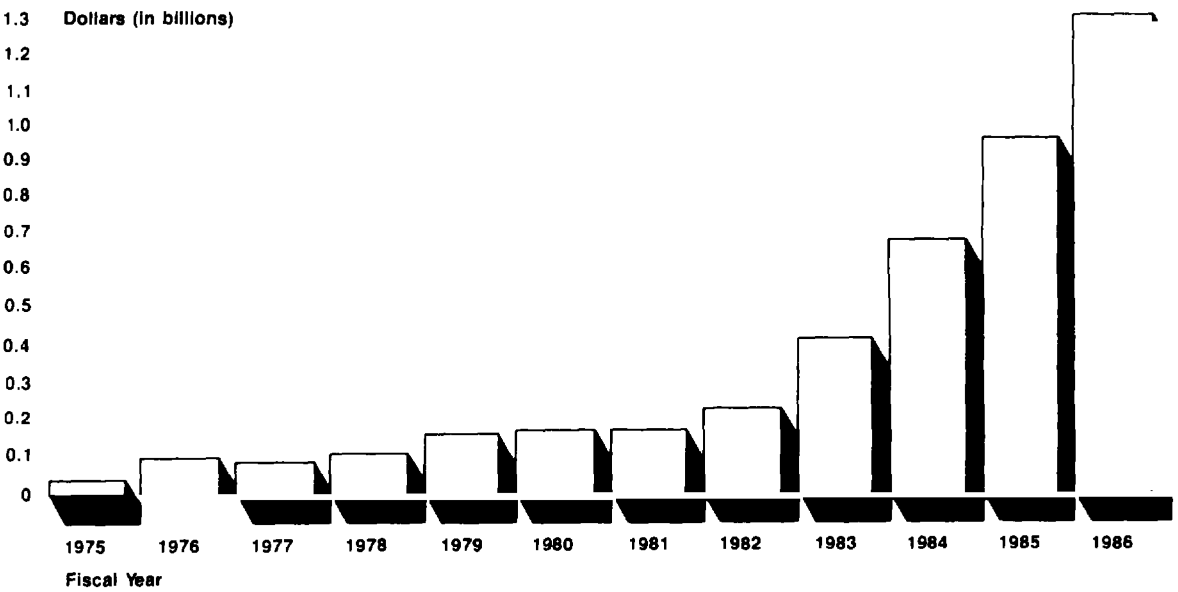
Reinsurance payments to guaranty agencies for defaulted loans are increasing greatly. Since 1965, the government has paid over $4 billion

[1]The Higher Education Amendments of 1986 allow agencies to retain 35 percent of their collections if a state has a qualified garnishment law.

[2]In our report Defaulted Student Loans: Guaranty Agencies' Collection Practices and Procedures (GAO HRD-86-114BR, July 17, 1986), we discuss the guaranty agencies' organizations and policies and procedures for collecting defaulted student loans

for defaulted loans under the program. Figure 1.1 shows the growth in reinsurance payments for fiscal years 1975-86. For example, reinsurance payments increased from $665 million in 1984 to $941 million in 1985 to about $1.3 billion in 1986. The rate of growth over these 3 years (95 percent) corresponds to the annual rate of growth of loans in repayment of about 106 percent over the same period.

Figure 1.1: Department of Education Defaulted Loan Payments to Guaranty Agencies



The Guaranty Agency—Key to Program Control

The authorizing legislation and program regulations give broad guidance on how the Guaranteed Student Loan Program is administered. Each guaranty agency has great flexibility in how it sets up its program. Not surprisingly, the agencies vary widely in design and administration.

All areas of the country have access to guaranty agency programs, with the last six agencies beginning operations in 1982—17 years after the first agencies started business. With guaranty agencies in all states, the Department of Education has ceased guaranteeing loans directly, as it did until July 1984 under the Federally Insured Student Loan Program. This program was similar to the current program, except that loans were guaranteed directly by the Department. The purpose was to ensure access to loans in jurisdictions not covered by guaranty agencies.

Guaranty agencies may be either state or private nonprofit organizations. Currently, there are 47 organizations serving as guaranty agencies in 58 jurisdictions. Forty-five of these organizations operate as the guaranty agency for a specific state or territory. The other two organizations—the Higher Education Assistance Foundation and the United Student Aid Fund—have national programs (they guarantee loans for the other 13 jurisdictions and in certain instances in jurisdictions that are also served by other agencies).

Due Diligence and Timely Filing

The authorizing legislation and program regulations require guaranty agencies to establish administrative and fiscal procedures that include, among other things, standards for lenders to follow to ensure (1) due diligence in making, servicing, and collecting loans and (2) timely filing of default, death, disability, and bankruptcy claims.

Before November 1986, federal regulations did not state precisely what constitutes adequate standards for due diligence and timely filing. The regulations defined due diligence as the lender's use of "practices at least as extensive and forceful as those generally practiced by financial institutions for consumer loans." The actual standards to be followed were to be established by the guaranty agency, as were requirements for timely filing.

On November 10, 1986, the Department of Education amended the regulations to implement various policy initiatives intended to ameliorate the types of weaknesses in lenders' and guaranty agencies' performance discussed in chapter 2. Effective March 10, 1987, agencies' standards must meet certain minimum requirements. Also, sanctions were established to help enforce compliance with the new requirements. These changes are discussed in more detail on pages 24 and 25.

Ensuring that lenders apply due diligence and make timely filing of claims are essential ingredients of a guaranty agency's performance. A proper level of due diligence helps to ensure that both the number of claims and the amount of each claim are as small as possible. Similarly, timely filing reduces the amount of interest paid on each defaulted loan and permits a guaranty agency to begin its own collection efforts as soon as possible.

The overall effect of adherence to standards is lower costs. By paying the smallest possible claim promptly, the guaranty agency reduces its cost and thus reduces the amount it seeks in reinsurance from the

Department of Education. Such reductions are in the federal interest—reinsurance payments during fiscal year 1986 were about $1.3 billion.

Lenders' compliance with standards and guaranty agencies' enforcement of them are required. According to federal regulations and lenders' agreements with guaranty agencies, lenders can seek reimbursement only for claims for which they have followed the guaranty agency's standards. Similarly, guaranty agencies are bound by the regulations and their agreements with the Department of Education to seek reinsurance payments only for such claims.

The Department of Education relies on the guaranty agency to ensure that lenders have performed due diligence and filed claims timely. The Department does not review each claim for compliance; rather, it performs limited postverification during periodic visits to guaranty agencies and lenders.

Objectives, Scope, and Methodology

We reviewed the systems and procedures under which the guaranty agencies and the Department of Education ensure compliance with due diligence and timely filing standards in paying default claims. We sought answers to the following questions:

1. Have guaranty agencies established collection and claim filing standards for lenders that are adequate to protect the federal interest?

2. Are guaranty agencies enforcing the standards they have established?

3. Are the guaranty agencies promptly processing and paying lender claims?

We made our review at Department of Education headquarters in Washington, D.C., and at six guaranty agencies in California, Connecticut, Florida, Illinois, New York, and Tennessee. Specific details about these agencies are contained in appendix I. We chose the six agencies for the following reasons:

- They are among the largest; together, they accounted for 32 percent of fiscal year 1984 loan volume. There is also considerable diversity in size, with New York's loan volume being 14 times that of Tennessee.
- They are geographically dispersed.

- They vary widely in their operating procedures and internal controls and had programs involving lenders of many types and sizes, allowing the review of claims from a diverse lender cross-section.

At each of the six guaranty agencies, we randomly selected 50 claim files from its universe of defaulted loan claims filed in fiscal year 1984. We reviewed these files to determine whether the agency had verified that the lender met the agency's loan collection and timely filing standards. We also evaluated each agency's internal controls and procedures and determined whether it had processed claims in a timely manner. Since we were interested only in the procedures followed in processing default claims, we looked only at those due diligence standards involving lender attempts to collect from the borrower. Moreover, we reviewed only data submitted by the lender to the guaranty agency in support of the claim—and not any other loan-related data retained by the lender—since the agency must assure due diligence on each claim based on information on hand before receiving reinsurance. We also discussed our analysis of each claim with guaranty agency personnel.

With this sample methodology we made valid statistical estimates for the six agencies. Since we did not select these agencies randomly, we did not project the propriety and accuracy of claims paid by the agencies to all agencies in the program.

At Department of Education headquarters, we

- reviewed documents and interviewed officials to determine how the Department establishes regulations for guaranty agencies and monitors agency operations;
- collected information concerning guidance the Department provides agencies and reviewed documentation from the Department's periodic agency reviews;
- examined the standards that guaranty agencies submitted to the Department, the Department's procedures for reviewing these standards, and the regulations the Department has established for agencies to follow when billing for reinsurance;
- reviewed the recent Department revisions to the regulations; and
- reviewed the results of the Department's Office of Inspector General audits of agencies and lenders.

We made program-wide conclusions and recommendations concerning the Department's internal procedures and controls over the administration of the program by all guaranty agencies.

We also visited some lenders who had submitted claims included in our samples. At each lender we interviewed officials responsible for administering student loans and reviewed documents to determine how the lender's program was organized and staffed, how its procedures for collecting student loans compared with those for regular consumer loans, and how it ensured that it complied with guaranty agency standards.

We conducted our review between February 1985 and May 1986. Our sample at each agency visited was drawn from claims paid during fiscal year 1984, the most recent fiscal year completed at the time of our review. The other data in the report were updated to reflect statistics and conditions at the end of fiscal year 1986.

Additional details on our methodology are contained in chapter 3. Our review was conducted in accordance with generally accepted government auditing standards.

Guaranty Agencies Have Not Developed Adequate Standards for Lenders to Use in Collecting Loans and Filing Default Claims

Guaranty agencies are responsible for establishing standards for lenders to follow in exercising due diligence in collecting loans and filing claims on defaulted loans. The six guaranty agencies we reviewed had not always set standards that were adequate to protect the federal interest. When compared to the Department's operations under the Federal Insured Student Loan Program standards, guaranty agencies we visited operated with less stringent standards for ensuring that lenders make all reasonable efforts to collect delinquent loans and file default claims in a timely manner.

An underlying problem was that federal program regulations in effect during our review did not clearly define what effective standards should contain. In turn, most guaranty agency standards we reviewed were not specific on what lenders must do to be in compliance. Also, the standards contained few provisions on what actions the agencies could take if lenders failed to comply. In November 1986, the Department issued revised program regulations, which, if enforced, should resolve the problems we identified.

Why Standards Are Important

Standards for collecting student loans are important for several reasons. First, student loans are in several respects a unique form of credit. For example, lenders generally perform a credit check and debt-burden analysis on consumer loan borrowers as a basic way of reducing the likelihood of loan default. These procedures are inappropriate for student loans, which are intended to enable applicants with little or no credit experience, significant income, or collateral to obtain loans.

Another unique feature of student loans is that, unlike other credit, the borrower generally begins repayment after several years rather than immediately. Moreover, students making payments may obtain additional repayment delays for various reasons. Consequently, student loans are intrinsically more risky than other loans, and the collection process is more complicated.

Clearly defined loan standards are also needed to ensure that agencies (1) reimburse lenders' claims only when lenders comply with loan collection and claim filing standards and (2) request reimbursement from the Department of Education only when they can assure that lenders made all reasonable efforts to collect defaulted loans before filing a claim. If agencies have not ensured that lenders made reasonable efforts to collect the loan and file a default claim—because either their standards are not adequately defined or they have not enforced them—their written assurances to the Department that the claims are valid are suspect. According to the Department's Office of the General Counsel, agencies that make inaccurate assurances are liable for the amount of reinsurance the Department paid on inaccurately certified claims.

In summary, adequately defined standards for collecting loans and filing default claims are the federal government's primary defense against incurring unnecessary costs. If lenders are sufficiently aggressive and forceful in collecting loans, they can encourage delinquent borrowers to follow repayment schedules, thereby reducing the risk that borrowers will default. If borrowers do default, costs to the federal government are kept to a minimum.

The Department's Review of Guaranty Agencies' Standards Has Been Inadequate

The Department of Education's regulations require guaranty agencies to submit their due diligence and timely filing standards to the Department for approval. In practice, a valid approval process did not exist. The criteria for approval were vague, and the Department did not know the approval status of agencies' standards. Meanwhile, the agencies that submitted their standards to the Department operate as if they had been approved.

Over the 20-year life of the Guaranteed Student Loan Program, the Department of Education has considered various options for determining the adequacy of guaranty agencies' loan collection and claim filing standards. During the first 10 years, for example, it did not attempt to more precisely define what lenders must do to collect insured loans. The Department required only that lenders "utilize procedures comparable to those generally used by commercial lenders for loans of comparable amounts which were not insured."

In November 1976, due in part to requests from lenders, the Department issued proposed regulations to define specific collection standards. Under the proposal, unless the guaranty agencies established their own standards, the agencies and lenders would have been required to follow mandatory federal collection standards similar to those the Department issued for the Federal Insured Student Loan Program. Comments on these proposed requirements raised a number of objections, which caused the Department to withdraw and revise the proposed regulations.

In April 1978, the Department proposed regulations to consolidate all existing and proposed standards and to implement program changes required by the Education Amendments of 1976 (Public Law 94-482). The proposed regulations would have required guaranty agencies to establish specific standards comparable to those under the federally insured program. The regulations, issued in 1979, were in effect when we made our evaluation. However, in response to guaranty agencies' objections, the Department dropped from the proposal the requirement that agencies' standards be comparable to the federal standards. Instead, in the preamble to its 1979 regulations, the Department stated that it would use the federal standards as a "guide" in judging the adequacy of an agency's proposed standards. The Department stipulated that agency standards could differ substantially from the federal standards only if the agency could show that its program warranted such a deviation.

The federal regulations require agencies to submit their proposed standards to the Secretary of Education to be reviewed "for administrative and fiscal sufficiency and for conformance to statutory and regulatory provisions." A Department official said that in 1981 the Department had begun reviewing standards submitted by the agencies. He further stated that, as of May 1986, it had approved the standards for 26 of the 47 guaranty agencies in the program. However, he could not provide documentation to support these statistics.

Our review of the Department's records showed that:

- While all 47 agencies had submitted standards for approval, the Department had evidence in its files that 9 were approved as of May 1986.
- There was no evidence showing whether the standards for the other 38 agencies had been reviewed. Also, we could not determine when a decision on approval was expected.
- The Department could not tell us how it evaluated the sufficiency of the standards and the extent of conformance with statutes and regulations. Thus, we could not determine what it considered acceptable or unacceptable in an agency's standards.

Guaranty agency officials told us that they had submitted their standards to the Department and were operating under the assumption that the Department had approved them. All of the agencies were receiving reinsurance.

Guaranty Agencies' Standards Were Not Adequate to Protect Federal Interests

The lender due diligence and timely filing standards developed by most of the guaranty agencies we visited were not adequate to protect federal interests. Generally, the standards lacked specificity and were unclear as to their sanctions for noncompliance. The agencies' use of inadequate standards increases the possibility that lenders are not exercising reasonable diligence and that the federal government is making reinsurance payments it should not make.

What Is an Adequate Standard?

To analyze the adequacy of an agency's due diligence and timely filing standards, we used two comparisons. First, we compared the standards to the Department's Federal Insured Student Loan Program standards because (1) they are the standards the Department follows when it is the direct insurer of student loans, and (2) the Department stated in the preamble to its 1979 regulations that the federal standards would be a basis for comparison. Second, we compared the standards of the six agencies to each other to determine whether the agencies followed certain common requirements.

We also reviewed each agency's standards to determine whether they specifically defined what a lender must do, or whether they merely served as a guide or recommended procedure. This was based on the requirement in the program regulations that a guaranty agency must (1) establish and disseminate its standards for due diligence and timely filing and (2) ensure that lenders abide by the standards. We infer from this requirement that agencies' standards must be sufficiently precise to be used as a measure of compliance.

While standards for lenders' due diligence and timely claims filing vary among agencies, they generally specify four broad categories: (1) collection attempts, (2) preclaims assistance, (3) final demand letter, and (4) timely filing of a default claim. In reviewing these standards, we also ascertained if sanctions, or some type of penalty, were to be applied if the standards were not followed.

Agencies' Standards Were Weak

Each of the agencies we visited had established lender standards that broadly covered the major categories of due diligence and timely filing. However, we found problems in certain areas—for example, in the number and timing of collection attempts and when lenders requested preclaims assistance. Generally, the standards were not specific on what lenders were to do or what would happen if they did not meet the standards.

Collection Attempts

Adequate due diligence standards should clearly define the type (letter or telephone call), number, and frequency of collection attempts to be made by lenders.

One of the most important ingredients of diligent lender collection efforts is timeliness. The lender should quickly recognize and act upon a borrower's delinquency because any delay can damage chances that borrowers will honor their repayment obligations. In addition, lenders can improve their chances of collecting by making several increasingly forceful collection attempts over time, letting borrowers know that lenders are pursuing them and preparing to take further action.

Recognizing this, the six agencies we visited had established lender standards for a required or suggested number of collection attempts. Table 2.1 compares these loan collection standards to the Federal Insured Student Loan Program standards.

Table 2.1: Agencies' Requirements for Attempting to Contact Borrowers With Delinquent Loans

Entity	Collection attempts: Number required	Collection attempts: Number suggested
Federal Insured Student Loan Program	4	•
Agency		
California	•	3
Connecticut	4	•
Florida	7	•
Illinois	4	•
New York	4	•
Tennessee	•	5

The federal collection standards required lenders to contact the borrower whenever a payment is 15 days delinquent and attempt to resolve the delinquency. Lenders must contact a delinquent borrower three more times if payment delinquency continues for 120 days. Three of the agencies we visited—Connecticut, Illinois, and Florida—set such specific, mandatory standards for lenders, also specifying how often these collection attempts are to be made. For example, these states specified a time at which the first collection contact—letter or telephone call—should be made. Like the federal standard, Florida and Connecticut required lenders to first contact borrowers not more than 15 days after a missed payment was due. Illinois required lenders to first contact borrowers within 20 days. Florida required six collection attempts at specific intervals (such as 20 days and 45 days after delinquency), and

Illinois required three further attempts at regular but unspecified intervals. Connecticut required three contacts—one each on the 35th, 55th, and 75th day of delinquency.

In contrast, the standards for the remaining states visited were not specific and were subject to interpretation. For example, New York required four contacts by the 90th day of delinquency, but did not state when the contacts must begin or at what intervals they must occur. Thus, lenders technically could fulfill the standard by making four collection attempts on the same day, a tactic that would lack the effect of progressively forceful collection attempts made over time. California and Tennessee included collection attempt schedules in their standards, but the number and timing of attempts were only suggested. These two agencies' standards provided that lenders' collection practices for program loans be as extensive and forceful as the practices they use for consumer loans.

Preclaims Assistance

An important part of collecting student loans and averting defaults is early detection and attempted resolution of payment delinquencies. To this end, under the Federal Insured Student Loan Program, the Department of Education requires that whenever a borrower is 60 days delinquent in making payment, the lender must request preclaims assistance. This requires the lender to formally notify the Department (as the guarantor of the loan) of the delinquency. The Department sends a series of letters to the borrower, urging him or her to contact the lender and begin or resume repayments. The Department will not pay insurance on a Federal Insured Student Loan Program claim if the lender failed to request preclaims assistance.

As shown in table 2.2, the six guaranty agencies require that lenders request assistance from them in attempting to resolve payment delinquencies. However, the requirements of five of the agencies are less stringent than the federal standards.

Table 2.2: Agencies' Requirements for Lenders to Request Preclaims Assistance and File Claims

	Lender actions (days payment delinquent)		
Entity	Request preclaims assistance	Send borrower final demand letter	File claim
Federal Insured Student Loan Program	60	90	210
Agency			
California	60	90	210
Connecticut	60	90	210
Florida	90	105	210
Illinois	90	90	120
New York	90	90	120
Tennessee	60	60	120

Final Demand Letter

When lender collection efforts, including guaranty agency assistance, are unsuccessful in resolving payment delinquencies, agencies' standards require a more forceful attempt to collect the loan. The lender is to send the borrower a final demand letter, stating that the outstanding balance be paid or the loan would be turned over to the guaranty agency for collection.

As shown in table 2.2, each of the six guaranty agencies established a timetable requiring lenders to send borrowers a final demand letter whenever the loan payment was delinquent, with individual requirements ranging from 60 to 105 days.

Timely Filing of Default Claims

Lenders' timely filing of default claims is important to minimize the costs of defaulted loans reinsured by the Department of Education. Until the lender submits a claim for a loan in default and the claim is paid by the guaranty agency, the Department continues to pay interest (including special allowance) on the loan.

Table 2.2 shows the six agencies' specified time limits for filing default claims. Three states' standards (as well as the federal standards) stated that claims be filed within 210 days of the date payment was delinquent. Three states' standards stated that claims be filed after 120 days.

Sanctions Unclear and Not Specific

A standard is of little value unless there are sanctions if it is not followed. Table 2.3 illustrates the sanctions that the six guaranty agencies could apply when lenders fail to follow certain standards.

Table 2.3: Agencies' Sanctions for Violating Selected Standards

	Sanctions for violating standards requiring			
Agency	**Timely collection attempts**	**Requesting preclaims assistance**	**Sending borrower final demand letter**	**Timely claim filing**
California	None	None	None	Claim rejected
Connecticut	None	Claim rejected	None	Claim rejected
Florida	Interest reduced	None	None	Interest limited
Illinois	None	Claim rejected	Claim rejected	None
New York	None	None	None	Interest limited
Tennessee	None	Interest reduced	None	None

In addition, the six agencies established general terms and conditions (including requirements in their agreements with some lenders) under which claims would be paid. For example, Connecticut's agreements stated that "failure to comply with requirements may result in disapproval of default claims, loss of federal interest benefits and [loss of] special allowance payments." Tennessee's procedures state that "acceptance or rejection of a claim may be made on the basis of the documentation submitted showing the diligence of the lender in his efforts to collect the debt."

However, the agencies we visited did not always define the actions they would take when lenders fail to meet a specific provision of their standards. As shown in table 2.3, for example:

- Five of the six agencies did not specify sanctions against lenders who failed to promptly initiate and continue attempts to collect from delinquent borrowers. Only the Florida agency's procedures provided for reducing the interest payable to lenders who failed to make the required contacts.
- Although each agency's standard generally required that lenders promptly request preclaims assistance from the agency to help locate missing borrowers and resolve payment delinquencies, three of the six agencies had no penalties for failing to request preclaims assistance. On

the other hand, both Connecticut's and Illinois' procedures stated they would reject claims for preclaims violations, and Tennessee's said it would reduce interest.

- Similarly, although all the agencies' standards required that lenders send final demand letters, only the Illinois agency provided a penalty for violating this standard. Its procedures provided for rejecting claims for this omission.
- While timely filing of default claims by lenders is important to limit the cost of defaulted loans, only four agencies provided penalties for failing to file default claims on time. Two agencies (California and Connecticut) provided for the rejection of late claims. In California lenders could cure rejected claims by performing certain additional collection activities, and in Connecticut lenders were allowed to appeal rejection decisions. Florida and New York said they would not pay lenders interest accrued past the filing deadline—210 and 120 days delinquent, respectively—on late default claims.

Without provisions for imposing penalties (such as limiting payments of interest to lenders), guaranty agencies presumably have two options when faced with a lender's noncompliance with its standards: pay or reject the claim. The first option is not satisfactory because it negates the reason for having due diligence standards.

Conversely, if rejection of a claim is the only method of insuring compliance, it may be too severe. The Federal Insured Student Loan Program standards serve as an example. Under these standards, all due diligence and timely filing actions are mandatory, and failure to perform them results in the lender's forfeiting insurance payments on the loan. In the early stages of that program, the Department found many lenders violating the standards, and it rejected numerous claims. Lenders complained to the Department and requested a case-by-case review of their claims, which was unmanageable because of the high incidence of lender violations. As a result, the Department established "cure" procedures in which it returned rejected claims to lenders, which could subsequently carry out the actions required by the standards, and refile the claims if they could not get the borrower to resume payments. However, similar procedures generally did not exist in guaranty agency standards we reviewed.

Similarly, as we show in chapter 3, the lenders we visited frequently did not comply with guaranty agency due diligence and timely filing standards. These violations ranged from relatively minor omissions, such as missing by 6 days the deadline for requesting preclaims assistance, to more serious violations, such as filing a default claim 10 months late. Under existing procedures, the agencies were faced with either rejecting the claim for any violation or ignoring the violation and paying the claim. We found that agencies frequently were reluctant to reject claims for lenders' noncompliance with their standards.

If guaranty agency procedures provided clear and reasonable penalties and opportunities to cure rejected claims, agencies could more readily refuse to pay claims in which lenders failed to comply with the standards. This would increase lenders' incentives to perform due diligence and meet timely filing requirements.

Department Has Established Minimum Requirements

The Department of Education amended its program regulations on November 10, 1986, to implement various policy initiatives intended to prevent loan defaults and to effect repayment of loans once default has occurred. The regulations continue to authorize guaranty agencies to set their own due diligence standards but require that the standards meet minimum requirements. The regulations also specified the sanctions that could be taken against lenders and guaranty agencies that fail to meet all program requirements.

Federal Due Diligence Requirements Placed on Lenders

Under the regulations, lenders will be required to perform, at a minimum, the following collection efforts in the event of a delinquency on a loan guaranteed by a guaranty agency. Delinquency begins on the first day after the due date of the first missed payment, or 30 days after the day the lender discovers that the borrower has entered the repayment period, whichever is later.

1. 1 to 30 days delinquent — Send at least two written notices or collection letters to the borrower.

2. 31 to 60 days delinquent — Make diligent efforts to contact the borrower by telephone. If unable to reach the borrower by telephone, send two forceful collection letters.

3. 61 to 150 days delinquent — During each 30-day interval in this period, make diligent efforts to contact the borrower by telephone; if unsuccessful, send at least one collection letter.

4. 151 to 180 days delinquent — Send a final demand letter, if the borrower's address is known.

5. Whenever the borrower's current address is unknown, lenders must promptly attempt to locate the borrower by contacting the loan endorser, relatives, references, and any others identified in the loan file.

6. Within 10 days lenders must request preclaims assistance available from the guaranty agency.

In the event of loan default (which is generally defined as 180 days after a borrower misses a payment), the lender has 90 days to file a default claim with the guaranty agency.

The federal requirements for lenders are effective for loans that become delinquent on or after March 10, 1987. The minimum federal requirements will generally require lenders to make more attempts to collect delinquent loans (7 collection letters and diligent telephone efforts vs. from 0 to 7 attempts) over a longer period of time (180 days vs. 120 days) than the standards used by the six agencies we visited. New federal sanctions will also require that lenders strictly adhere to the required time frames for attempting to collect loans and filing claims.

Penalties Available Against Lenders and Guaranty Agencies

Under the regulations, the Department may require lenders to repay interest and special allowance on a loan during the period that they fail to comply with the federal loan collection and 90-day timely claim filing requirements.

Under the regulations, guaranty agencies will not be eligible for reinsurance payments on a loan for which the lender did not meet all of the minimum federal loan collection and timely filing requirements <u>or</u> the agency did not pay the default claim within 90 days of the date the lender filed the claim. The regulations also allow the Secretary of Education to impose other penalties, including suspension or termination from the program, for violations of federal requirements.

While the regulations will require that agencies strictly enforce lender compliance with federal minimum requirements, in an effort to provide for less severe penalties, agencies may establish "cure" policies under which the guarantee coverage on a loan for which the lender violated a condition of payment may be reinstated. These regulations, if properly implemented and enforced, should remedy the problems we noted. However, as discussed in the next chapter, the agencies did not enforce the prior regulations, and the Department did not routinely monitor compliance.

Guaranty Agencies Need to Improve Their Internal Systems and Procedures to Control Program Operations and Costs

Department of Education regulations did not assure that guaranty agencies established and maintained adequate systems to control program operations and costs. At most of the guaranty agencies we visited, the procedures for reviewing, processing, and paying lenders' default claims were not always adequate to ensure accurate payments and minimize processing times, resulting in excess default claims (principal and accrued interest) and interest subsidy payments by the Department of Education.

Of the 300 sample default claims we reviewed, 50 percent could have been returned or rejected, based on agencies' standards and agreements. We estimate that during fiscal year 1984, the six guaranty agencies we reviewed paid $83 million for claims that the agencies could have rejected or returned to lenders for additional collection efforts because they did not comply with the agencies' standards.

The guaranty agencies paid these claims because (1) the Department of Education generally reimburses them in full for their payments to lenders regardless of their enforcement practices and (2) the agencies have not established effective claim review procedures to detect lenders that have not exercised due diligence in collecting loans.

Why Effective Control Procedures Are Needed

Adequate procedures for reviewing, processing, and paying lenders' default claims are needed at the guaranty agencies because (1) they are required under Department of Education regulations, (2) the program is currently administered by 47 agencies that annually pay more than 327,000 lender claims costing about $1 billion, and (3) the Department relies on the agencies to properly bill it for amounts eligible for federal payment.

Under federal regulations and Department of Education agreements with guaranty agencies, each agency must:

- Agree to establish and maintain administrative and fiscal procedures that the Secretary of Education may require to ensure proper administration of the agency's loan insurance program.
- Disseminate standards and procedures to program lenders.
- Ensure that lenders exercise reasonable care in collecting loans.

The regulations also require agencies to submit statements of procedures and standards when requested by the Secretary of Education and when changes or new materials are proposed. The Secretary is required to review these materials for administrative and fiscal sufficiency and conformance to statutory and regulatory provisions.

Forty-Seven Agencies Administer the Program

Each of the 47 guaranty agencies has considerable flexibility in how it is organized and operated to administer and control program operations and costs. Given the large number of agencies, the diversity in the types of organizations and operating procedures, and the growth in the number of claims, an adequate system to control program operations is critical to ensure that claims are accurately and appropriately paid.

Agencies' payments for lenders' claims, and thus the cost of reinsurance to the Department, are growing. As shown in figure 1.1 (see p. 10), annual reinsurance payments increased gradually between 1975 and 1982, reaching $209 million in fiscal year 1982. Due partly to sharp increases in the number of new loans during the last 6 years, however, reinsurance payments increased dramatically after 1982. Payments in fiscal year 1986 were $1.3 billion, a 38-percent increase over 1985, a 95-percent increase over 1984, and a 220-percent increase over 1983.

Department of Education Relies on Agencies to Pay Claims

The Department relies on guaranty agencies to submit accurate, proper reinsurance billings. The Department reviews each billing to check for mathematical accuracy and duplicate payments before it pays it. However, the Department does not verify that lenders exercised due diligence in collecting loans or filing default claims; rather it relies on the agencies' assurances that lenders complied with their standards. Also, the Department does not routinely evaluate whether guaranty agencies promptly reviewed and paid lender claims to minimize interest costs. The Department, while it looks to the agencies to operate this aspect of the program, conducts a program of postaudits by its program review staff to evaluate lenders' compliance and the propriety of its reinsurance payments.

Effective control procedures are important because, although the guaranty agencies have the role of approving lenders' claims, the Department retains the ultimate responsibility to pay claims through reinsurance. Controls are needed to ensure that the agencies properly consider the federal interest.

Guaranty Agencies Did Not Always Enforce Their Standards

According to their procedures and agreements with lenders, the six guaranty agencies we reviewed could deny a default claim or refuse to pay it in full if lenders do not comply with certain standards in attempting to collect the loan. In the 300 claims we reviewed, however, the agencies generally paid lenders the full amount of their claims, even when lenders did not fully comply with standards.

Sampling Procedures and Methodology

During fiscal year 1984, the six guaranty agencies paid lenders $249 million for about 80,800 defaulted student loan claims. The Department of Education reimbursed agencies for these payments based on the agencies' assurances that lenders made all reasonable efforts to collect the loans from the borrowers.

We randomly selected and reviewed 300 default claims the agencies paid to lenders during fiscal year 1984. For each sample claim, we analyzed the documentation in the guaranty agency's files to determine (1) what the lender had done to collect the loan, (2) whether the lender's collection efforts complied with the guaranty agency's standards, and (3) the number of days for which lenders received accrued interest and interest subsidies on defaulted loans. We also recomputed the payment to the lender to verify that it was accurate and proper, based on the agency's requirements.

According to guaranty agencies' procedures as we discussed in chapter 2, agencies can reject or refuse to pay in full default claims when lenders have not made sufficient efforts to collect loans or have not filed claims promptly. In addition, some agencies' procedures state that the agency may reduce the amount of interest it will pay lenders when they fail to perform specified collection requirements. For example, Florida's procedure states the accrued interest to which a lender was entitled would be reduced for the periods during which the lender failed to promptly initiate or aggressively continue attempts to collect delinquent loan payments from the borrower.

When reviewing the evidence in the 300 sample claim files, we determined whether the agency paid or rejected the claim in accordance with its procedures. If it did, we judged that payment to be proper. If an agency paid a claim it could have returned or if it failed to reduce the reimbursement amount as provided for in its procedures, we concluded that the agency's payment was inappropriate.

Analysis of 300 Sample Claims

Our analysis of the sample claims showed that the average amount agencies paid lenders for a defaulted loan was $2,800, ranging from $110 to $14,600. In nearly two-thirds of the cases, the borrower did not make any payments. The claim files also showed that lenders' efforts to collect loans and avert default varied widely. For example, while lenders sent an average of 5 collection letters or notices to borrowers, the number of letters ranged from 0 to 25. Similarly, lenders made an average of 4 phone calls to borrowers, ranging from 0 to 25.

Almost half of the 300 claims were paid despite failure by lenders to provide evidence that they had complied with agency standards. As shown in table 3.1, we concluded that 129 of the 300 claims (43 percent) were paid correctly. However, 150 (50 percent) of the claims could have been denied because they did not meet agency standards, and another 21 (7 percent) contained errors the agency made in calculating payments to lenders.

Table 3.1 GAO Conclusions on the Propriety of Claim Payments

	States							
	CA	CT	NY	FL	IL	TN	Total	Percent
Sample size	50	50	50	50	50	50	300	100
GAO conclusions:								
Payment proper	42	43	16	20	3	5	129	43
Payment inappropriate:								
Claim could have been rejected	5	4	34	17	47	43	150	50
Incorrect adjustment	3	3	0	13	0	2	21	7

Payment of 129 Claims Was Proper

Guaranty agencies properly paid 129 claims; in these cases, lenders met the agencies' standards or the agency assessed penalties in accordance with its standards. For example, 43 of the 50 Connecticut claim files had evidence that the lenders (1) performed the required collection activities, (2) requested preclaims assistance, (3) filed both the default claim and documents needed to support the payment of the claims, and (4) were penalized when they did not comply with the agency's standard. We found that when lenders did not submit the required documentation, the Connecticut agency generally returned the claim and later obtained the needed documents. In accordance with its standards, the agency reduced the amount of interest payments to lenders for 21 of these claims.

150 Claims Could Have Been Rejected

The six guaranty agencies paid 150 claims that they could have rejected because their claim files did not contain evidence that the lenders complied with due diligence standards. For example, the files for 47 claims paid by the Illinois agency did not contain evidence that lenders had appropriately requested preclaims assistance, sent the borrowers final demand letters, or were timely in performing these tasks. Illinois' procedures allow the agency to reject a claim for failing to meet these procedures; however, the agency did not reject any of these claims.

The files for 17 claims paid by the Florida agency showed that lenders did not comply with the agency's standards. For example, in eight claims, lenders had not promptly initiated collection on delinquent borrowers. They requested preclaims assistance 3 to 11 months late and filed default claims 1 month to more than 2 years late.

The Department of Education is paying more for default claims (in principal and interest) than it should because agencies are not ensuring that lenders are complying with agency standards. During fiscal year 1984 the six guaranty agencies paid lenders $249 million for about 80,800 claims. Based on our analysis of claims in our sample, we estimate that the six agencies paid at least $83.5 million on more than 33,600 claims that could have been denied.[1]

Guaranty Agencies Did Not Correctly Compute Claim Payment Amounts

Four guaranty agencies did not correctly compute the amount paid on 21 (7 percent) of the 300 claims. We found errors at four of the six agencies visited. (See table 3.1.) For example, the Florida agency erroneously paid interest (ranging between 30 and 330 days) on 6 claims for which lenders did not meet the agency's standards. Under the Florida standard, interest is payable for a maximum of 120 days when a lender has not met the standards. While our analysis indicates that the incidence and amount of erroneous payments had no significant effect on total payments to either the agencies or lenders, we believe their occurrence demonstrates that the agencies' procedures for calculating claim payment amounts could be improved.

[1] At the 95-percent confidence level, we estimated that between 33,600 and 44,400 claims, for which lenders were paid between $83.5 and $136.4 million, could have been denied by the six guaranty agencies in 1984.

Guaranty Agencies' Controls Over Claim Processing Varied

Claim processing procedures, which provide for verifying lender due diligence before paying claims, must also provide for efficient and reasonable controls over the accrual of interest and special allowance costs. Until a claim is paid, interest accrues and the lender continues to bill the Department for the special allowance. Thus, even if a lender exercises due diligence and files the claim in a timely manner, the federal government can incur unnecessary costs if the guaranty agency does not have sufficient procedures for controlling the interest and special allowance that accrue during its review and processing of the claim. Some guaranty agencies, we found, failed to establish claim processing standards to limit these costs and reduce the amount of reinsurance paid by the Department.

All Six Guaranty Agencies Had Some Limits on Interest Paid to Lenders

One method for controlling the amount paid on a claim is to limit the number of days interest is payable to lenders. These limits generally pertain to the number of days interest can be paid for (1) lender processing from delinquency to submission of the claim to the guaranty agency and (2) guaranty agency processing of the claim until payment to the lender.

Lender Processing Limits

Connecticut's procedures limited interest payments to either 120 or 150 days from the date of delinquency, depending on whether the borrower ever entered repayment. California limited interest to 120 days on each claim that had to be returned to the lender for additional documentation to support the claim. New York, Florida, and Illinois reduced interest payments on each claim that lenders filed after their filing deadlines. Illinois also reduced interest payments for periods that the lender failed to perform loan collection activities in a timely manner. Tennessee capped interest payments at 183 days on any claim for which the lender failed to request preclaims assistance in a timely manner.

Guaranty Agency Processing Limits

Five guaranty agencies limit interest payment to a specific number of days the agencies spent in processing lenders' claims. Of these, three agencies—Connecticut, California, and New York—had standards to limit the payment amount by the time it spent processing a claim by 15, 45, and 90 days, respectively, after claims were received from lenders. Two other agencies, Tennessee and Florida, instituted a 30-day claim processing time standard during or after our review. Illinois did not have a claim processing standard.

Delays in Filing and Processing Claims Affect Interest Subsidy Payments

In addition to accrued interest paid lenders by guaranty agencies, lenders are also entitled to continue to receive interest subsidy (special allowance) payments directly from the Department of Education until the claim is paid by the guaranty agency. Thus, the longer it takes lenders to file default claims and agencies to process and pay the claims, the greater the amount of interest subsidy the Department pays lenders.

As with accrued interest payments, lenders were entitled to interest subsidy payments for an average of 282 days, ranging from 53 to 1,569 days, at the six guaranty agencies. In a number of instances, the federal government was liable for interest subsidy payments for more than 2 years.

Federal Interest and Interest Subsidy Accruals for Default Claims

The amount of accrued interest and special interest allowance paid to lenders for their claims varied considerably among the six agencies. These payments recognized lenders' entitlements to interest and interest subsidy for (1) delinquencies occurring between periods of repayment, (2) delinquencies at the time of default, (3) time taken by the guaranty agencies to pay the claims, and (4) limits to processing claims imposed by agency standards. Table 3.2 shows that for the 50 claims we reviewed at each agency, lenders received interest costs for an average of 282 days, ranging from 53 to 1,569 days.

Table 3.2.: Number of Days Lenders Received Accrued Interest and Interest Subsidy Payments for Defaulted Loans

Guaranty agency	Days lenders paid interest: Average	Range
California	273	135–808
Connecticut	148	53–720
Florida	302	100–592
Illinois	455	94–1 569
New York	305	77–933
Tennessee	206	177–566
Overall	**282**	**53–1,569**

It is to the government's benefit for agencies to promptly pay claims to minimize accrued interest and interest subsidy costs. Table 3.3 shows that federal costs for accrued interest and interest subsidies would increase by $9.3 million for each 30 days claim payments were delayed. The estimates, which are based on 1985 defaults and average Treasury Bill rates, also show that federal costs on claims paid by the six agencies we visited would increase by $4.1 million for each 30-day period.

Table 3.3: Potential Impact of Claim Processing Delays on Federal Costs for Loan Defaults

Dollars in millions

	1985 Defaults		Increased federal costs for processing delays of (days)		
	Number	Amount	30	60	90
All agencies	327 328	$950 3	$9 3	$18 6	$27 9
Six agencies	138 391	414 6	4 1	8 1	12 2

Factors Contributing to Guaranty Agencies' Ineffective Enforcement

We believe guaranty agencies were ineffective in enforcing their lenders' compliance with due diligence and timely filing standards because most had inadequate claim review procedures and practices, all lacked financial incentives, and all were committed to reimburse lenders for all losses on their loans.

Agencies Lacked Effective Procedures for Reviewing Lenders' Claims

Guaranty agencies' enforcement efforts were hampered by the lack of effective procedures and practices to review claims submitted for payment by lenders. Without an effective claim review system, a guaranty agency cannot detect and penalize lenders who do not follow its standards in collecting loans. The agency therefore cannot assure the Department that lenders meet the due diligence standards on claims submitted for reimbursement.

Three Agencies Lacked Written Review Procedures

At the time of our review, the Tennessee, Illinois, and New York guaranty agencies lacked complete written claim review procedures.

For example, until January 1985 the Tennessee agency processed claims manually and without any written procedures. The agency staff did not require that lenders provide documentation on claims submitted for payment. They relied on an agency policy that "in the absence of violation of general standards of due diligence, lenders shall be presumed to have performed due diligence in the making, servicing, and collecting of GSLP loans." Agency reviewers used their judgment to determine the amounts to be paid lenders. This resulted in the inconsistent application of procedures for calculating the interest payments to lenders. During fiscal year 1984 the agency developed a significant backlog of lender requests for preclaims assistance and for the payment of default claims.

Because the size of its staff was limited by state appropriations, in January 1985 the agency hired a contractor to service its loans and verify that lenders were complying with the standards.

In Illinois, lender claims were processed without written agency procedures for verifying that lenders complied with due diligence and timely filing standards. The agency did not document its review of default claims submitted by lenders. Thus, we were not able to assess lenders' performance or audit the propriety of the amounts the agency paid lenders.

The three agencies that did not have written procedures for reviewing claims paid—Tennessee, Illinois, and New York—had the highest number of claims that could have been rejected because of noncompliance with due diligence standards. (See table 3.1.) Nevertheless, the guaranty agencies paid all of the claims.

Agencies With Written Claim Review Procedures

Two guaranty agencies we visited, Connecticut and California, had written procedures requiring them to verify and document that all lender claims were reviewed for compliance with their requirements. Eighty-five of the 100 claims we reviewed in these two agencies were paid in accordance with agency standards and procedures.

In Connecticut, claim analysts use detailed checklists to verify both the receipt of proper documentation and compliance with each due diligence standard. These checklists not only standardized the review process and assured coverage of lender compliance in all areas of due diligence, but also provided documentation of the review and its result.

In California, the agency's collection contractor uses a computerized claim review process. Claim reviewers respond to computerized prompts to check proper documentation, due diligence actions, and timeliness. If all standards are met, the system generates the check paying the lender's claim. Even with this system, California's review practices were incomplete because (1) the contractor relied solely on data on the lender's claim form and did not verify these data with available records and (2) the agency's procedures did not assure that interest paid lenders was limited to 120 days when the claim was returned to the lender for additional documentation. After we brought this matter to their attention, California agency officials said they would revise their claim form, verify key data affecting the claims, and make adjustments to refund amounts paid for interest in excess of 120 days.

Until January 1984 the Florida agency lacked written procedures for reviewing default claims. The agency and the Department of Education believed the agency was understaffed. At the end of 1983 the agency had what it considered a large backlog of 2,000 unpaid default claims and 2,500 requests for preclaims assistance. Beginning in January 1984 it contracted out its claim review function. The contractor developed procedures to improve claim processing and reduce the backlog. Because these new procedures were put in place during our review, we could not evaluate their impact.

Agencies Lack Financial Incentives

Under the Guaranteed Student Loan Program, both lenders and guaranty agencies are protected against the threat of significant financial losses from defaulted loans. Whenever a student defaults, the lender receives reimbursement for the outstanding principal and accrued interest if it followed the agency's standards.

While the six agencies' procedures included terms and conditions under which lenders' claims may be denied, our review showed that lender claims were paid regardless of the extent to which lenders complied with standards. Although guaranty agencies in some instances reduced the interest paid to lenders when they did not meet due diligence and timely filing standards, lenders received reimbursement for the outstanding principal and at least some of the accrued interest on all claims.

Under federal regulations in effect at the time of our review, guaranty agencies' default payments to lenders were generally fully reimbursed (reinsured) by the Department of Education. The Department lowered the reinsurance amount when an agency's annual default rate reached a certain point, but few agencies reached that point. For those that did, the reductions in reinsurance were small (10 or 20 percent) and applied only to defaults for the remainder of the fiscal year after the date the limits were reached. In fiscal year 1985, 37 of the 58 agencies received 100-percent reinsurance on all default payments to lenders. The other 21 agencies received 100-percent reinsurance for most of their payments to lenders. Overall, agencies were reimbursed for almost 98 percent of their payments to lenders. Thus, agencies had no financial incentive to enforce standards since they could generally expect to recoup whatever they paid regardless of whether lenders followed the standards. This is significant because the Department does not verify lenders' compliance with agency standards before paying reinsurance; it relies on the agencies' assurances that the lenders meet the standards.

Agencies Generally Perceive a Need to Pay All Lenders' Claims

When a lender arranges to provide a student loan, it obtains a written commitment from the guaranty agency that, if the lender meets agency standards, the agency will reimburse the lender if the student borrower does not repay. Our review showed that guaranty agencies' operating policies and practices are designed to honor these commitments, whether or not lenders complied with the standards. The following paragraphs give examples of five states' policies and practices.

The Florida procedures stated that a lender's claim may be rejected or an interest penalty may be assessed whenever the lender does not comply with the guaranty agency's standards. Florida agency officials agreed that some of the claims in our sample could have been rejected under its standards, but it elected to pay the claims albeit with an interest penalty. Agency officials said that the procedures include the option to reject a claim to "encourage" lender compliance.

Illinois agency officials told us that they are committed to honoring the guarantee given at the time the loan is made and thus will pay all lender claims. They said the agency considers its lender manual to be a training document, and compliance with its requirements is not mandatory for claims to be paid. The manual contains highly persuasive language and instructions, they said, in order to encourage lenders to perform collection efforts with diligence.

The Tennessee agency operated on the basis that its published standards were not required lender collection activities and that in the absence of evidence that the standards were "violated," a lender was presumed to have been diligent in collecting loans. The agency paid lender claims without requesting additional required documentation on claims under the philosophy that lenders were guaranteed they would be reimbursed for losses.

In June 1983, the California guaranty agency designed a new system for reviewing lender compliance with its standards. Of the first nearly 1,950 claims the agency reviewed, about 1,680 (86 percent) could have been denied because they did not comply with the standards. For example, lenders frequently failed to document repayment schedules, final demand letters, preclaims assistance requests, or the dates loans were converted to repayment. Instead of denying the claims, however, the agency paid all of them, except for 236 claims that were returned to the lenders for the required documentation. The agency also expected to waive its documentation standards for an additional 5,000 claims it had on hand and for all claims received from lenders during the next 9 months because lenders could not readily provide the required documentation. After April 1, 1984, lenders were expected to provide the documentation necessary to adjudicate lender claims in accordance with the agency's standards. Thus, before this date the agency paid lenders for claims without evidence that the lenders complied with its standards.

The Connecticut agency paid three claims to lenders that had missed the 210-day filing deadline by as many as 300 days. Agency officials told us that the agency paid these claims because the violations occurred during a period in which lenders were experiencing difficulties and delays in establishing new automated record-keeping systems. While they were establishing the new systems, the lenders could not readily comply with the standard. The agency files, however, did not document the rationale for making payments under such exceptional circumstances in violation of the standards.

Revised Regulations Should Improve Controls Over Program Operations

The Department of Education's November 1986 issuance of revised program regulations established claim processing standards and required the guaranty agencies to develop their own procedures of internal controls. Compliance with the requirements should result in better controls over program operations and reduce default costs.

Claim Processing Requirements

As discussed in chapter 2, the Department's regulations require lenders to file a default claim within 90 days of default. Lenders are no longer eligible for interest and special allowance for any period of time they exceed this requirement, and they must repay any payments incorrectly received. In addition, guaranty agencies are required to pay default claims within 90 days after they were received from lenders. Thus, under the revised regulations, the Department has stated that guaranty agencies are responsible for enforcing lender compliance with claim filing standards and to promptly pay those claims in order to be eligible for reinsurance payments.

Enforcement and Compliance Reviews

The amended regulations delegated greater responsibilities to guaranty agencies to enforce program requirements. For example, agencies must (1) establish procedures and controls to ensure that lenders are complying with all federal, state, and agency requirements; (2) at a minimum, conduct biennial on-site program reviews at their 10 largest participating lenders and any other lender whose loan volume equaled or exceeded 2 percent of the value of all loans guaranteed; and (3) seek prompt repayment of all funds found to be improperly paid to or retained by lenders and monitor the implementation of corrective actions required as a result of its program reviews.

Each guaranty agency must also establish administrative procedures to include an independent biennial financial and compliance audit of its guaranteed loan program. The audit must (1) examine the agency's compliance with program legislation, regulations, and agreements; (2) examine the agency's financial management of its loan guaranty program; and (3) be conducted in accordance with generally accepted standards for financial and compliance audits.

We believe these regulations better define internal control objectives and should contribute to improved internal controls over program operations and costs. Like the prior regulations, issued in 1979, the Department requires that agencies submit their statements of procedures and standards, as well as other materials that substantially affect the operation of the program, whenever changes and new materials are proposed. The new program rules differ from the prior regulations in that they provide that with a few exceptions, the "agency may use these materials unless and until the Secretary disapproves them." In this regard, the Department has not established a plan, including specific milestones and time frames, to review agency statements of operating procedures, standards, and internal controls as provided in the regulations.

Conclusions, Recommendation, and Agency Comments

Conclusions

The Department of Education has delegated broad responsibilities for administering the Guaranteed Student Loan Program to guaranty agencies. The Department relies on these agencies to control program operations and ensure that claims lenders submit for payment are eligible for federal reimbursement. Department regulations in effect during the period of our review required agencies to set and enforce:

- Standards lenders must follow to ensure that diligent practices were followed and that claims were promptly filed to minimize the government's cost.
- Procedures for their own operations to limit the time needed to process lender claims and thus minimize interest and special allowance costs for which the federal government is the ultimate payer.

Guaranty agencies' standards for lenders' due diligence and claim processing, and their procedures for enforcing the standards, were not always adequate to protect the federal interest. The standards used by the agencies we visited were frequently not sufficiently specific as to the requirements for reasonable and timely efforts by lenders to collect loans or file default claims. For example, standards at five agencies did not require lenders to request preclaims assistance from guaranty agencies in a timely manner.

In addition, the six agencies' procedures for enforcing the standards did not always define sanctions to be imposed on lenders failing to meet program requirements. The agencies were not adequately ensuring that lenders were in compliance with their standards. For example, three agencies lacked formal procedures for reviewing and documenting lender compliance with loan collection or timely claim filing standards. All six agencies chose not to deny payments to lenders for not meeting due diligence standards, even though the procedures allowed such denials. We concluded that payment of 150 (50 percent) of 300 claims paid by the six agencies we analyzed could have been denied if the agencies enforced their standards. Based on the results of our sample, we estimate that during fiscal year 1984, these six agencies paid about 33,600 claims totaling more than $83.5 million that they could have denied.

The six agencies varied widely in their policies and procedures limiting the amount of interest paid on lender claims. As a result, agencies' payments to lenders for interest costs—costs that are passed on and paid by the federal government—averaged 282 days, ranging from 148 to 455 days.

The ultimate responsibility for these problems rests with the Department of Education. The Department's program regulations in effect during the time of our review gave little guidance to the agencies in setting their standards and procedures. Moreover, the Department did not effectively review the agencies' standards, nor did it require the agencies to implement a system of strong internal controls.

In November 1986, the Department issued revised program regulations which, if enforced, should remedy the shortcomings we noted regarding lender due diligence and claims processing. These regulations require guaranty agencies to (1) adopt minimum federal standards for collecting loans and filing default claims; (2) establish and implement an enforcement strategy to ensure lender compliance with all federal, state, and agency requirements; and (3) establish administrative procedures, including a biennial independent financial and compliance audit that examines the agencies' compliance with federal law, regulations, and agreements, and its financial management of the loan guarantee program. The revised regulations also clarified sanctions the Department and agencies can use against lenders and agencies not in compliance with program requirements. For example, lenders and guaranty agencies will not be eligible for interest, special allowance, or reinsurance payments for any defaulted loan in which federal requirements were violated.

We believe that the Department's revised regulations established standards and requirements that, if implemented by the Department and the guaranty agencies, should correct the problems we found, improve the program's operations, and reduce the costs of defaulted loans. However, the Department's past performance, as discussed in this report, has not been effective in assuring that the guaranty agencies are enforcing lender requirements and following internal procedures. The Department still needs to develop and implement a process to ensure that the guaranty agencies are properly and promptly implementing the new regulations and that the federal government's interests are protected. For example, under the revised regulations, agencies are required to submit their statements of procedures and standards for review by the Department and they may use these standards "unless and until the Secretary disapproves them." The Department needs to establish timetables and milestones for reviewing and approving agencies' procedures, standards, and internal controls.

Recommendation to the Secretary of Education

We recommend that the Secretary develop and implement a process to systematically review and approve guaranty agencies' (1) standards for collecting loans and filing claims and (2) statements of internal controls and administrative procedures required to be developed and implemented under the new regulations. Such a system should include specific milestones and timetables for the Department of Education to use in approving the agencies' standards and statements.

Agency Comments and Our Evaluation

We furnished a draft of this report to the Department of Education and the six guaranty agencies we reviewed. The Department and the California Student Aid Commission, Connecticut Student Loan Foundation, Tennessee Student Assistance Corporation, and New York State Higher Education Services Corporation provided comments.

Department of Education

On May 21, 1987, we met with the deputy assistant secretary for student financial assistance and other officials of the Department's Office of Postsecondary Education. The officials generally concurred with the information and conclusions in our report. Regarding our recommendation that the Department systematically review and approve guaranty agencies' loan collection and claim filing standards, and internal control and administrative procedures, the officials stated that the Department plans to (1) review and approve guaranty agencies' application forms and promissory notes and (2) rely on its periodic reviews of each guaranty agency's activities—particularly those related to defaulted loans—to ascertain whether the agencies are complying with federal due diligence and timely filing requirements specified in the regulations.

While we agree that the Department's program review activities are a vital part of its effort to oversee guaranty agencies' activities, we do not believe such after-the-fact reviews will ensure that the agencies have implemented the requirements in a timely manner. If the Department follows its current schedule for conducting these reviews, it will take about 2 years to complete the reviews of all of the agencies. Rather, we continue to believe that it is important for the guaranty agencies to comply with the new regulations by promptly submitting their statements of procedures and standards to the Department and that the Department promptly review them to assure compliance with the requirements.

California Student Aid Commission

The California Student Aid Commission concurred with our recommendation and suggested technical revisions, some of which we made in finalizing our report.

Connecticut Student Loan Foundation

The Connecticut Student Loan Foundation concurred with our recommendation. However, the foundation noted that it had in some instances been included with the other agencies in general statements of inadequate performance, when it had performed significantly better than other agencies. We agreed and made appropriate revisions to our report.

Tennessee Student Assistance Corporation

The Tennessee Student Assistance Corporation stated that it had improved the corporation's standards and procedures to correct the problems we found. The corporation believed that our conclusion that many of its claims in our sample could have been rejected was based on an overly strict interpretation on our part of Tennessee's due diligence requirements.

We continue to believe that our conclusions regarding the Tennessee agency's claims were appropriate. For 43 of the 50 cases we reviewed, the corporation's case files did not contain evidence that lenders had performed such required functions as requesting preclaims assistance or sending final demand letters in a timely manner.

New York State Higher Education Services Corporation

The New York State Higher Education Services Corporation disagreed with our characterization that it has no sanctions for lenders who fail to follow required collection standards. We continue to believe that the corporation had not specified sanctions in its standards. However, the corporation established, after our review, procedures to impose sanctions on lenders not in compliance with its standards.

The corporation also disagreed with our determination that 24 of the claim files we reviewed lacked sufficient evidence that lenders had followed required procedures—primarily sending past due collection notices and final demand letters. The corporation said that the banks in question for a significant number of the claims did not have to submit documentation because they had automated systems for sending collection notices. Also, while the dates notices were sent are not available in the files, it said it verifies that notices are sent as part of its periodic audits of lenders.

We continue to believe that the files we examined lacked adequate documentation that the lenders followed required procedures, and thus the claims could have been rejected by the agency. The corporation's standards require that such documentation be included in claim files. The Department of Education believes that such documentation should be included in the claim files unless it grants an exception. While the corporation said it had approved lenders' automated systems, Department officials said they had not provided an exception to the New York agency.

Further, our work showed that one of the banks identified by the corporation had experienced computer problems during the period of our review, and had implemented manual processes for sending final demand letters, but could not document that the letters were mailed. Also, two of the banks that submitted claims in question were not among those the corporation identified as having an automated collection system at the time of our review.

Fiscal Year 1984 Volume and Costs of Default Claims the Department of Education Paid Guaranty Agencies Visited

Dollars in millions

Agency	Default claims paid: Number	Default claims paid: Dollar value	Cumulative gross default rate[a]
California Student Aid Commission	22 287	$65 7	10 7
Connecticut Student Loan Foundation	5,778	18 2	9 2
Florida Department of Education, Office of Student Financial Assistance	5,946	16 6	6 4
Illinois State Scholarship Commission	8,900	28 7	10 2
New York State Higher Education Services Corporation	37 085	117 2	11 1
Tennessee Student Assistance Corporation	826	2 5	4 9
Total	**80,822**	**$248.9**	

[a]Ratio of the value of default claims paid to lenders to the value of loans that enter repayment (mature paper) as reported by the Department of Education

Recent GAO Reports and Testimony Related to Guaranteed Student Loans

Reports

Guaranteed Student Loans:
Better Criteria Needed for Financing Guarantee Agencies
GAO/HRD-86-7, 7/2/86

Defaulted Student Loans:
Guaranty Agencies' Collection Practices and Procedures
GAO/HRD-86-114BR, 7/17/86

Guaranteed Student Loans:
Guidelines for Reducing Guaranty Agency Reserves
GAO/HRD-86-129BR, 8/7/86

Testimony

The Department of Education's Actions to Collect Defaulted Student Loans (Statement of William J. Gainer, Associate Director, Human Resources Division, General Accounting Office, Before the Subcommittee on Postsecondary Education, House Committee on Education and Labor), 6/19/85

*U.S. G.P.O. 1987- 181-236:60029